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Bitcoin, Currency Debasement, and Alternative Investing

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I wrote the book on vulture investing. **FULL BIO**

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These days, I can hardly read any news without seeing a new mention about Bitcoin. This new, blockchain-based currency seems to appreciate every day. When I attend alternative investment conferences around the world, nearly every investor is talking about it. Why is Bitcoin so popular and is it in a bubble? How does current investor demand for it compare with stated demand for alternative assets in general?

A Bitcoin isn't a tangible asset like a stock certificate, a bond, or gold bullion. It's a digital currency that exists on a decentralized network of computers located around the world that keep track of all Bitcoin transactions. The transactions are recorded on an open-source ledger—the blockchain—that is constantly updated and viewable by anyone participating in the network.

Like stocks and commodities the price of Bitcoin is determined by bidding on exchanges and can be extremely volatile. At the beginning of the year the price of a single Bitcoin was less than $1,000, but it has climbed dramatically since then, particularly in the last few weeks. The price broke the $10,000 barrier on November 28 and then really took off, gaining $5000 in one 48-hour period to hit an all-time high of $18,000 on December 7, but dropping more than $3000 by the next morning.

Why is Bitcoin so popular? The answer lies in the long-term debasement (through low interest rates and money printing) of fiat currencies around the globe. Fiat currencies are those backed by nothing other than an expectation that their central bankers will manage them prudently. For example, ever since President Nixon announced the U.S. would no longer convert dollars to gold at a fixed value in 1971, the dollar moved from gold backing (where USD $35.00 was readily convertible into an ounce of gold) over to a free float. Since then, U.S. dollars are backed by nothing other than the "full faith and credit" of the United States, as written on each buck. As you would expect, the greenback has therefore steadily depreciated since then and one ounce of gold is worth USD $1,248 today. The problem with fiat currencies is that, inevitably, central bankers have a terrible long-term track record of managing supply prudently. For example, the U.S. Central Bank expanded its balance sheet by ~$4 trillion after the Great Recession in 2008. Nearly a decade later, it has only just started to reverse prior quantitative easing efforts with monthly reductions of only $6-8 billion! Moreover, interest rates (otherwise known as the price of money) remain extremely low. In fact, the Bank of England recently published research showing that today's risk free interest rates are near an 800-year low! That's why Bitcoin is so popular – because its block chain technology promises to objectively control supply in an environment where central bankers have proven an inability to effectively do so.

Is Bitcoin a bubble? Although many commentators suggest it is, the answer to this isn't so clear to me. I've witnessed many bubbles over the years, the Internet mania, the housing bubble, fixed income bubbles of all sorts, the NASDAQ bubble, the art bubble, just to name a few. I've also read about historic bubbles, like the Tulip Mania and the railroad bubble. Most bubbles include circumstances where money supply was abundant and leverage was readily available similar to what we see today. However, not many bubbles included a potential solution to the problem of long-term fiat currency debasement. Moreover, Bitcoin's overall current total market capitalization remains well below what it would be if it were to become a major substitute currency. Thus, it's hard to conclude that Bitcoin is currently in a bubble even though it has appreciated spectacularly of late.

One final observation about Bitcoin is that alternative investors speculating on it seem to be acting more rationally than those who've dialed down their alternative asset return expectations. Institutional investors and their consultants often tell us these days that they're no longer looking for big gains from alternative investments. Instead, they say that they would prefer steady returns (6-8%) without any big drawdowns. However, many of these same investors are flooding into Bitcoin speculation lately. The answer to this conundrum is twofold: (1) greed and fear are driving alternative investors into Bitcoin (greed of achieving big returns and fear of missing out) while (2) lack of good recent returns from the largest alternative asset managers (the big safe bets that many consultants have recommended for years) are causing them to dial down their overall return expectations for alternative assets. An important lesson can be learned from all this – strong returns will generate strong investor demand so don't change your strategy because consultants tell you that investors no longer want to make money!

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